

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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THE DILEMMA: GROW OR GIVE UP

Australian companies need to be more disciplined in their quest for growth. Past failures, however egregious, should not cause us to throw in the towel.

Paul Kerin, a business school professor, has argued recently that many Australian companies have failed the growth strategy test. Growth through product and geographic diversity has not brought the benefits sought and companies have been reluctant to shed underperforming businesses, according to Kerin.

Unfortunately, his observations about Australian corporate behaviour come dangerously close to saying that doing nothing is a preferred corporate course. For the sake of shareholders and the welfare of the nation, however, growth should be encouraged as long as it is more focused on what drives value.

There is ample evidence of Australian companies failing their shareholders through poor strategic decision-making. Australian companies have had appallingly short life cycles many being confronted by near death experiences of various sorts, or even worse, succumbing permanently.

Even with a casual glance through the leading Australian listed companies one can pick those like Westpac, Foster's, Axa, Brambles, Burns Philp, Fairfax, Southcorp, National Australia Bank and Coles Myer which have survived but not without severe scarring during the past 20 years. To this list could be added all the major media companies. Then there are others which have not pulled through or have been dismembered and reformed. Examples like Pacific Dunlop, MIM Holdings, CSR and Western Mining come to mind.

At any point in time it seems that another is reliving the Australian corporate nightmare. Presently, it is AMP.

Strategic overreach seems to be the trip-wire; going one step too far. Many companies have come to grief through unwise international expansions. The small Australian market and its geographic remoteness from places in which Australians feel comfortable doing business create additional risks for Australian companies (and their shareholders).

However, it is too easy to infer that companies should not expand their product or geographic bases lest they also succumb. After all, many of the companies crippled by a single strategic misadventure were once hailed for their strategic wisdom. Sometimes the accolades acted as the spur to do more. Having the resources to make the big mistake depended on a prior history of successful expansion.

How can one tell whether a company is within one step of the big mistake? Should Australian companies become so risk averse that they eschew growth from this point unless it is within some pre-defined core products and core geographic locations? This outcome would be a great pity for Australia and Australian investors.

Two companies which have successfully diversified their businesses in recent years and used by Kerin as examples of being on the verge of going too far are Wesfarmers and Foster's. The example of Foster's actually illustrates the folly of trying to identify 'too far'.

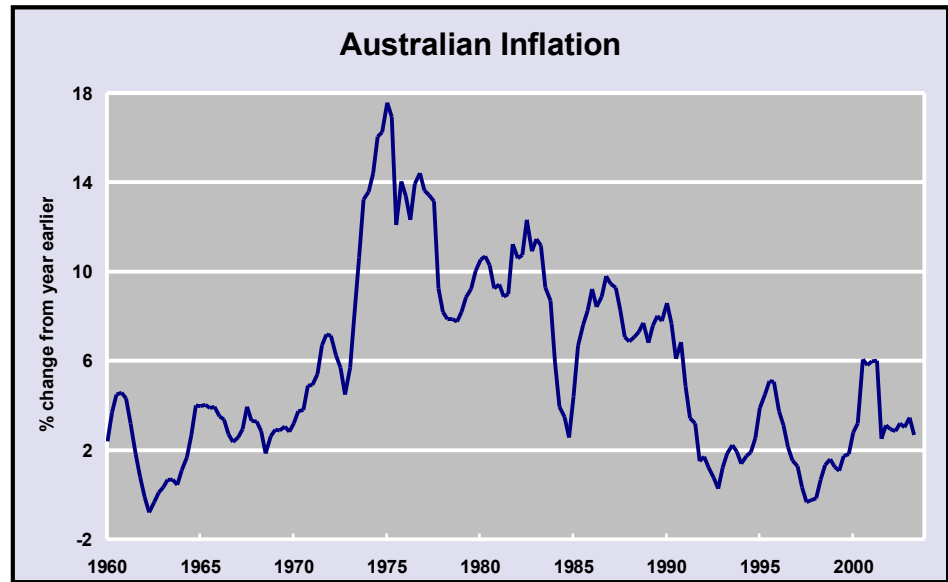
"The absence of a consistent benchmark against which companies continually measure their performance is one of the failings which afflicts the Australian equity market."

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THE WEEKLY CHART SPOT

The benefits of having low inflation rates more in line with international counterparts show up through:

- less downward pressure on the exchange rate;
- less upward pressure on interest rates; and,
- more competitive industry.

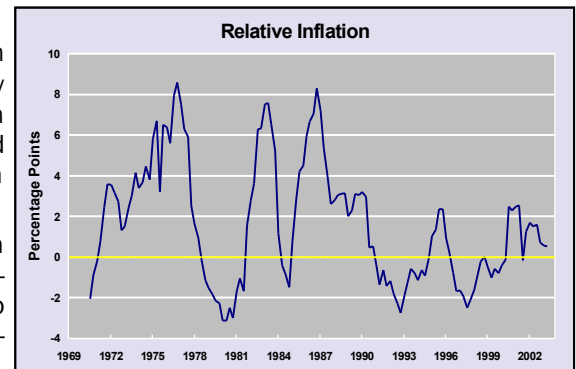


Source: Australian Bureau of Statistics

Australia's consumer price index rose by 2.7% over the year to the June quarter of 2003, slightly above the 2.4% average rate of price increase (before adjusting for the effects of the goods and services tax introduction) since the beginning of 1992.

Australia's inflation performance has gone through four distinct periods.

- Prior to the oil price shock in the early 1970s, there were relatively low rates consistent with the benign 25 year post war economic environment.
- With the oil price shock in the early 1970s higher inflation rates became embedded in the Australian economy through the combined effects of centralized wage setting, a depreciating currency and tariff protection for large parts of manufacturing industry.
- During the 1980s, there was an arduous adjustment with policy directed at making Australian business more competitive and during which time the inflation trend was down.
- In the post-1992 period, inflation was finally reined in to acceptable rates and kept within two percentage points of the US outcomes (shown opposite).



EXECUTIVE PAY: THE SPIN STOPS HERE CONT'D

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salaries are so often provided without the performance tests being made explicit.

Of course, directors will argue that performance criteria should be held confidential because they relate to an individual. However, we are not talking about the car park attendant here. The goals set for the CEO are indistinguishable from those of the company.

By refusing to disclose the CEO's performance goals, directors are saying that

shareholders should not be privy to the company's goals and, by further implication, they are not entitled to know how effectively management is delivering against the goals being set.

Solving this tension between shareholders and directors can be relatively straightforward but requires a commitment from directors to follow a more rigorous reporting regime than they have been used to facing. *thebigpicture* solution is on page 4.

THE DILEMMA: GROW OR GIVE UP CONT'D

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Banning aggressive geographic expansion would have ruled out the company's brewing arm moving from its Victorian base where it accounted for over 90% of the market into New South Wales, Queensland and Western Australia during the 1980s and 1990s where its share had been negligible. It now holds shares of those markets which once would have been unthinkable. The idea that a Victorian brand could supplant the local icons might have been regarded as strategic overreach. Better to go offshore!

Of course, going back even further, the ban on expansion would have prevented Carlton and United Breweries being formed in the first instance from the plethora of Victorian breweries which had been servicing the local market.

The question for Foster's now is not so much whether its brewing business will be scaled back but how it will avoid the great Australian failure by taking that one strategic step too far - this time in wine.

Similarly, for Wesfarmers, might it make one acquisition too many and ruin all of what has gone before just like so many of the conglomerates which have preceded it?

However, the important ingredient for success is a commitment to achieving adequate rates of return. Too often companies have been pushed into strategic initiatives to be seen to be active. Chief executives are surrounded by baying analysts, corporate advisers and even boards

EXECUTIVE PAY: THE SPIN STOPS HERE CONT'D

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This is no new era of stingy executive pay because Morgan will almost certainly receive a high and rising salary. And, if he does not meet the goals set for him and the board has to terminate him, the Westpac annual report will show him getting a minimum of \$3.4 million for that year.

Most people get their base salary for doing what their job requires. Getting a bonus usually depends on achievements over and above what is necessary to keep the job. Therein lies one tension between directors and shareholders: the disparity between real world conditions and those for chief executives.

But the most important misgiving about

populated by former and current corporate advisers whose wealth has depended on high volumes of corporate activity. There is an institutional bias in Australia for the innovative and headline grabbing transaction and not enough emphasis on what adds fundamental value for a sustainable business.

Perhaps what characterizes the success of Wesfarmers and, in more recent times, Foster's is the commitment in both cases to getting an adequate return for shareholders from the funds employed in their businesses. Other companies, too, which have adopted this discipline have seemingly improved their decision-making. Amcor is another example which comes readily to mind now despite its geographic diversity.

On the other hand, one could cite Southcorp as an example of a company which made the transition from conglomerate to single purpose group with disastrous consequences. Seduced by the allure of wine and the clamour of others for the change, Southcorp divested higher returning but far less glamorous businesses to get where it is today.

The absence of a consistent benchmark against which companies continually measure their performance is one of the failings which afflicts the Australian equity market. Establishing such a benchmark publicly would be an important step in ensuring discipline and avoiding the adoption of strategies driven simply by the desire to be active. **thebigpicture** solution is on page 4.

the Westpac scheme is that it purports to be so thorough - we are told, for example, the expected volatility of the Westpac share price over the coming four years for purposes of valuing options which might be granted is 19% - but fails the biggest test. There is no commitment to identifying the benchmarks which need to be reached to deliver the majority of the CEO's cash salary.

Westpac lost an opportunity to improve its position with its shareholders and to help improve the lot of shareholders generally. Sure, there is some element of envy but the fundamental problem with the way executive remuneration is set is that higher

"...many of the companies crippled by a single strategic misadventure were once hailed for their strategic wisdom. Sometimes the accolades acted as the spur to do more. Having the resources to make the big mistake depended on a prior history of successful expansion."

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EXECUTIVE PAY: THE SPIN STOPS HERE

More detailed reporting of CEO remuneration is beginning to occur but directors seem reluctant to embrace the most important aspect of public disclosure.

The Westpac board announced in the past week that the term of appointment of its current chief executive, Dr David Morgan, had been extended. Included with the announcement were several pages describing the conditions on which the appointment had been made including details relating to

- the base salary;
- the magnitude of potential short term and long term incentive payments including cash, shares and options; and,
- payments due in the event employment is terminated either voluntarily or involuntarily.

Two pressures have prompted the detail. One is the regulatory requirement to announce the terms of chief executive contracts as soon as possible after an appointment or after a change in arrangements has

occurred. The other pressure is the need to respond to criticisms of seemingly excessive executive payments: a multi-million dollar payment might be more palatable among shareholders if its possibility has been advertised widely beforehand.

To further avert some of the public hostility to big payments, Westpac sought to represent the Morgan package as a new age in remuneration because the CEO salary has been fixed for the duration of the new contract at the same level as the CEO's current salary. However, before

applauding, consider the bigger picture.

As well as his \$1.7 million base salary, the Westpac CEO will also be entitled to a rising bonus if he meets annual performance criteria set by the Westpac board. The bonus payment in the initial year of the contract is equivalent to 100% of the base salary and rises in each subsequent year by 10%.

Executive Pay & The Growth Dilemma: The Solution

Public accountability for corporate strategy has become entwined with executive remuneration. Companies with an effective communication programme on both fronts are seen as more shareholder friendly and less risky as investments. They will be worth more than a similar company that does not have such a programme.

For many companies, making the change would be a considerable cultural shift. Yet instilling a new discipline in corporate behaviour could be a surprisingly simple three-step process.

- *Directors would commit to setting objectives consistent with the company improving its economic returns with a clear definition of what directors meant by that concept.*
- *These objectives would be reported on in the annual report and at the next AGM (with an explanation of how remuneration is to be tied to these outcomes).*
- *A report would be made at the subsequent AGM (and in the annual report) on:

 - the prior year's performance and its remuneration consequences,
 - any remedial action which might be required, and
 - the new set of objectives for the coming year.*

Interim reporting, continuous disclosure and management discussion and analysis would occur within this framework.

A commitment to these processes would go much further to improving shareholder relations than the slew of corporate governance guidelines which companies must now negotiate.

Even then there will be mistakes from time to time but they are less likely to fester as they can now. They will be acknowledged more readily than they are now and dealt with more swiftly.

Put bluntly, he can get \$1.7 million for just showing up. He gets another \$1.7 million (and rising) for doing his job.

If Morgan achieves the goals set for him by the board he will receive \$3.4 million in the first year of the contract. In the fourth year of the contract, he will receive \$4.0 million, an increase of 16.6%.

Compared with his total compensation in the year to September 2001 of \$2.5 million, he will have received a 60% gain over six years.

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